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STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/21/05**	Bill No:	**AB 1618**
Tax:	**Sales and Use**	Author:	**Klehs**
Related Bills:			

BILL SUMMARY

This bill would provide a sales and use tax exemption on tangible personal property used to manufacture alternative fuel prototype buses pursuant to a qualified research and development contract, as defined.

Summary of Amendments

The prior version of this would have required business property statements that are filed with county assessors for property tax purposes to include information regarding sales or use tax paid on acquisitions of the property identified on the statements and allow that information to be shared with the Board of Equalization (Board) as specified.

ANALYSIS

Current Law

Existing law imposes a sales or use tax on the gross receipts from the sale of, or the storage, use, or other consumption of, tangible personal property, unless specifically exempted by statute. Under existing law, gross receipts include all amounts received with respect to the sale, with no deduction for the cost of the materials used, labor or service cost, or any other expense of the retailer passed on to the customer. When sales tax does not apply, use tax is imposed and is measured by the sales price of property purchased from a retailer for storage, use, or other consumption in California. The use tax is imposed on the person actually storing, using, or otherwise consuming the property.

Regulation 1501.1 details how persons engaged in the business of providing services pursuant to a qualified research and development contract are consumers of tangible personal property which they use in providing the service. Tax applies to the sale of the property to them. The regulation sets forth the requirements for, and the application of tax to, qualified research and development contracts, and explains in part, the following:

A **qualified research and development contract** is a contract for a service where: (1) the service provided under the contract is undertaken for the purpose of discovering information which is technological in nature, the results of which are intended to be useful in the development of a new or improved product, process, technique, or invention; and (2) the contract calls for the delivery of a report detailing information developed by the contractor or other tangible personal property incidental to the true object of the contract.

Additionally, a qualified research and development contract would not include a contract for research for the purpose of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors. A qualified research and development contract is not a contract for the design and production of a custom-made item.

Prototypes

In a qualified research and development contract for informational and testing purposes, as defined below, sales or use tax applies to the sale of tangible personal property to the contractor, but any prototype transferred from the contractor to the purchaser is not subject to tax.

Regulation 1501.1, subdivision (a)(7) defines "**Informational and Testing Use**" as:

(1) Testing for verification of a design to specifications.

(2) Developing data, algorithms, ideas and/or knowledge to improve or perfect a design.

(3) Determining alternative design features and implementations.

(4) Validating testing of software and firmware embodied within a design.

(5) Demonstrating operation of a design for approval by a customer.

(6) Quality assurance and performance testing to determine limitations and failure modes of the design.

A prototype, in a qualified research and development contract, is used for informational and testing purposes and is also used for verification that a design meets the required technical specifications of the contract. No functional use of the prototype is made. Regulation 1501.1, subdivision (a)(6) defines "functional use" as a use for which the property was designed which occurs after completion of the research and development.

Sales of additional prototypes transferred in a qualified research and development contract for purposes other than informational and testing use, where a functional use occurs, are subject to tax. The amount subject to tax is the stated value of the property in the contract, or if none is stated, at the computed fair market value as determined by applying a factor of three to the cost of direct materials used in the production of the prototype.

Custom-Made Items

Contracts to design, develop, and manufacture custom-made items do not meet the requirements for qualified research and development contracts, and therefore are a contract to sell tangible personal property. In general, custom-made items are intended for functional use and not for informational and testing use. Tax applies to the entire contract price, including charges related to rearch, design, and development activities.

Proposed Law

This bill would add Section 6368.11 to the Revenue and Taxation Code to exempt from the sales and use tax the sale or purchase of "qualified equipment" sold to a "qualified person." This bill provides the following definitions:

"Qualified equipment" means tangible personal property that is used to manufacture alternative fuel prototype buses pursuant to a qualified research and development contract.

"Qualified person" means a contractor who provides integration and installation of fuel cell components for a public transportation agency that is a member of the California Fuel Cell Partnership and has a demonstration site.

"Qualified research and development contract" means a contract for informational and testing use pursuant to paragraph (7) of subdivision (a) of Section 101.1 of Title 18 of the California Code of Regulations, as filed on February 21, 1996.

As a tax levy, the bill would become effective immediately upon enactment but the provisions would become operative on the first day of the first calendar quarter commencing more than 90 days after the effective date.

Background

Fuel cell technology has captured worldwide attention as a clean power source for electric vehicles. Fuel cell technology uses hydrogen with oxygen from air to produce electricity. The electricity generated powers a vehicle's motor. In principle, a fuel cell operates like a battery. However, unlike a battery, a fuel cell does not run down or require recharging. It will produce electricity as long as fuel, in the form of hydrogen, is supplied.

In January 1999, the California Fuel Cell Partnership (CaFCP) was formed in an effort to promote fuel cell vehicle commercialization as a means of moving towards a sustainable energy future, increasing energy efficiency, and reducing or eliminating air pollution and greenhouse gas emissions. The CaFCP is a collaboration of industry and governmental agencies whose goals include demonstrating fuel cell vehicle technology by operating and testing vehicles under real-world conditions in California.

The California Air Resources Board (ARB) expressed an interest for a demonstration program in investigating the feasibility and market potential of fuel cell technology. The ARB, in February 2000, approved regulations to reduce emissions from transit buses in California. The goal of the Public Transit Bus Fleet Rule and Emission Standards for New Urban Buses was to reduce overall emission of particle matter and oxides of nitrogen through use of alternative technologies. These technologies include alternative fuel buses and the demonstration and eventual purchase of zero emission bus technologies. Zero-emission technologies include battery electric, electric trolley, and fuel cell.

As previously stated, a primary goal of the CaPCP is to demonstrate fuel cell vehicle technology by operating and testing the fuel cell transit buses under real-world conditions in California. Currently, three California transit agencies are members of the CaFCP and have demonstration sites: Alameda-Contra Costa Transit District (AC Transit) in Oakland, SunLine Transit Agency (SunLine) in the Palm Springs area, and Santa Clara Valley Transportation Authority (VTA) located in San Jose.

In 2003, AC Transit entered into a contract with ISE Research Corporation, a fuel cell integrator, and United Technologies Corporation (UTC), a manufacturer of fuel cell systems, for the delivery of four 40-foot fuel cell buses for their demonstration program (three buses for AC Transit and one for SunLine). AC Transit has plans to evaluate the

bus performance in comparison with their diesel buses, focusing on service in hilly areas, freeway express service to San Francisco, and service on heavy-travel lines with over 71 million passengers per year. AC Transit also operates a hydrogen fueling station at its Richmond Energy Station in partnership with Stuart Energy and the California Fuel Cell Partnership. Although the station currently can fuel only passenger cars, AC Transit plans to upgrade it to accommodate refueling of the three fuel cell buses. SunLine already operates a hydrogen refueling facility which is being used under the California Fuel Cell Partnership for these types of fuel cell transit application demonstrations.

In 2002, the VTA entered into a contract with Gillig Corporation and Ballard Power Systems for the procurement of three 40-foot Gillig buses powered by Ballard's fuel cell engines. VTA plans on evaluating fuel cell technology for the public transit industry, including maintenance and operating performance and costs, fuel safety, employee training, and public education and awareness. This is a joint demonstration program with VTA, the San Mateo Transportation District, the California Fuel Cell Partnership and the California Air Resources Board.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the AC Transit in an effort to improve the environmental health and the quality of life in the communities it serves. AC Transit is determined to find technological solutions to environmental challenges. According to the sponsor, reducing pollution from our diesel fleet is good, but not good enough. To have a truly clean-air fleet, AC Transit says it must explore a variety of alternative fuel development programs. Within the next two years, AC Transit will be acquiring three, state-of-the-art, zero-emission, hydrogen fuel cell buses and a fleet of zero-emission, light-duty vehicles. AC Transit's Hy-Road program aims to demonstrate to the world the viability of an emission-free transit fleet. This demonstration program will be monitored and evaluated for performance and public acceptance by the Department of Energy's National Renewable Energy Laboratory and by the Institute of Transportation Studies at UC Davis.

2. **Exemption would apply to contractors who provide prototypes pursuant to a qualified research and research development contract.** This bill would define a "qualified person" to mean a contractor who provides integration and installation of fuel cell components for a public transportation agency that is a member of the California Fuel Cell Partnership and has a demonstration site. Regulation 1501.1 provides that transfers of prototypes for informational and testing use pursuant to a qualified research and development contract are not subject to tax. The contractor is a consumer of tangible personal property which they use in providing services under a qualified and research development contract. Tax applies to the sales of such property to the contractor. However, under the provisions of this bill, the sales of tangible personal property to the contractor would be exempt from the tax.

3. **Definition for "qualified equipment" needs clarifying.** This bill would define "qualified equipment" to mean tangible personal property that is used to manufacture alternative fuel prototype buses pursuant to a qualified research and development contract. This should be clarified. Does the term include pencils and paper used to document results of testing of the prototype? If a computer is used to prepare a report about the prototype, is the computer exempt from the tax?

4. **Currently, only three public transportation agencies are members of the California Fuel Cell Partnership.** Those agencies are Alameda-Contra Costa Transit, SunLine Transit Agency, and Santa Clara Valley Transportation Authority. This bill would define a "qualified person" to mean a contractor who provides integration and installation of fuel cell components for a public transportation agency that is a member of the California Fuel Cell Partnership and has a demonstration site. Thus, the contractors providing integration and installation of fuel cell components to these three agencies would be the persons entitled to the exemption in this bill.

5. **Definition of "qualified research and development contract" Should be added to the statute.** This bill references the Board's Regulation 1501.1, *Research and Development Contracts*, for the purposes of defining a qualified research and development contract. However, a preferable approach would be to incorporate the definition of this term in the bill consistent with the regulation. This way the statute is complete on its own. Board staff is willing to work with the author's office to develop a definition that applies to the research and development contracts in this bill.

COST ESTIMATE

Some costs would be incurred in notifying affected taxpayers and revising the regulation and pamphlets. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Persons engaged in the business of rendering services pursuant to a qualified research and development contract are consumers of tangible personal property which they use incidental in rendering the service. Generally, tax does not apply to receipts derived from qualified research and development contracts.

A "qualified research and development contract" means a contract for informational and testing use pursuant to paragraph (7) of subdivision (a) of Section 1501.1 of Title 18 of the California Code of Regulations. Additionally, the service provided under the contract is undertaken for the purpose of discovering information which is technological in nature, the results of which are intended to be useful in the development of a new or improved product, process, technique, or invention; and the contract calls for the delivery of a report detailing information developed by the contractor or other tangible personal property incidental to the true object of the contract.

This bill would exempt from sales and use tax tangible personal property that is used to manufacture alternative fuel prototype buses pursuant to a qualified research and development contract. The exemption extends to a contractor who provides integration and installation of fuel cell components for a public transportation agency that is a member of the California Fuel Cell Partnership and has a demonstration site.

The scope of this proposed exemption is narrow and defined to a population of only two contractors that could meet the criteria for the exemption:

(1) Alameda-Contra Costa Transit District (AC Transit), a member of the California Fuel Cell Partnership, who has contracted with ISE Research Corporation for the acquisition of four prototypes "Fuel Cell Buses". The delivery of these buses to AC Transit is scheduled for the Fall of 2005. The total contract price for these four buses is approximately $10.7 million. According to a representative of ISE Research, the value of tangible personal property used to manufacture the four alternative fuel prototype buses amounts to $5.9 million of the contract price.

(2) The Santa Clara Valley Transportation Authority (VTA) has already received delivery of three "Fuel Cell Buses" for demonstration from Ballard Power Systems Inc. in conjunction with Gillig Corporation. The VTA's fuel cell buses were contracted at a price of $10.6 million. The buses were placed in service on February 24, 2005. Since the VTA buses have already been delivered and placed into service, this estimate only includes the tangible personal property specific to the AC Transit District's fuel cell buses and their contractor ISE Research Corporation.

Revenue Summary

The revenue impact of exempting $5.9 million in tangible personal property that is used to manufacture alternative fuel prototype buses pursuant to a qualified research and development contract amounts to a loss of $467,000 in State and Local sales and use tax as follows:

	Revenue Loss
State (5.25%)	$ 309,750
Local (2.0%)	118,000
District (0.67%)	39,530
Total	$ 467,280

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